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LOS ANGELES BAR BULLETIN

LOS ANGELES BAR ASSOCIATION ORGANIZED 1888

In This Issue

JUNIOR BARRISTERS' EDITION.

VOL. 23 NOVEMBER, 1947 NO. 3

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Official Monthly Publication of Los Angeles Bar Association. Entered as second class matter October 15, 1943, at the Postoffice at Los Angeles, California, under Act of March 3, 1879. Subscription Price $1.00 a Year; 10c a Copy.

VOL. 23 NOVEMBER, 1947 No. 3

A WORD FROM THE JUNIOR BARRISTERS CHAIRMAN

THE Junior Barristers Committee wishes to thank the Board of Trustees and Bar Bulletin Committee Chairman Frank Balthis for giving us this opportunity to participate more fully in the affairs of the Association. This is the first time in many years that the BULLETIN has been turned over to the Junior Barristers.

During the war years, our Committee quite naturally lacked the manpower to take any active responsibility in Bar Association work. The past year and a half has seen the return from service of many of our members, and it was the desire to have these men act on our Committee that prompted last year's Chairman, Dolph Roome, to be so insistent that the By-Laws be amended to exclude from the seven years' practice qualification at least three years of the time spent in service.

Junior Barrister members have served actively on each of the Bar Association committees. On request for "a few" members of our Committee to act on the panel of the Federal Court Criminal Defense Committee, enough of our members volunteered to have at least one member in Federal Court on each arraignment day. In addition, our monthly luncheon meetings have been well attended, with from one-quarter to one-third of our total membership present at most of our meetings.

This enthusiasm of our members for Bar Association work is not enough unless the Association allows that interest a properly guided outlet. It is for that reason that we appreciate the foresight of the Board and of the Bar Bulletin Committee in turning this issue over to us. We now realize more fully the effort required in putting out an issue of the BULLETIN, and in such realization will be better qualified in later years to accept the responsibilities of the Association which will one day of necessity be ours.

CAMERON W. CECIL,
Chairman, Junior Barristers Committee.

SOME BASIC TAX PROBLEMS ARISING OUT OF THE COMMUNITY PROPERTY SYSTEM

By Robert Leo Spencer, C. P. A. and Member of the Los Angeles Bar

THE light of publicity is being focused more and more these days on the community property system and its attendant problems. For many years this subject was of interest to the people in only eight states, one of which was California. Of late, however, five additional states have adopted the community property system, at least temporarily, and many others are considering similar action.

Undoubtedly, the goal of the states which are now embracing community property for the first time, is to obtain for their residents the personal income tax advantages which stem from the system. There is no denying that considerable tax savings frequently result when a husband and wife are permitted to split community income for income tax purposes. On the other hand, the community property system imposes serious responsi-

bilities on the spouses and raises concomitant tax and legal problems not present under a common law property set-up. It is probable that most laymen and many attorneys are not aware of many of the tax complications which a community property system generates.

It is the purpose of this article to comment briefly on just a few of these problems, with emphasis on those affected by recent legislation or litigation. It is not to be inferred that the situations covered herein are extraordinary or unusual; on the contrary, it has been the writer's experience that one or more of them will apply to almost every propertied client. Unfortunately, they are sometimes overlooked to the severe detriment of the taxpayer.

INCOME FROM PROPRIETORSHIPS AND PARTNERSHIPS

Owners of unincorporated businesses are confronted with the problem of classifying the income therefrom as between separate and community. Where the entire capital invested in an enterprise is "new" community (acquired subsequent to July 29, 1927), there is no problem of segregation since all of the income will also be "new" community. If, on the other hand, the capital invested is separate or "old" community in whole or in part, and both capital and the proprietor's personal services produce income, it is important taxwise that the segregation be performed.

This basic problem of apportioning the income of a venture between the personal services of the spouse-proprietor and the invested capital has arisen in connection with property rights as well as taxes. The prevailing rule in California as set forth in *Pereira v. Pereira,* 156 Cal. 1, may be summarized as follows:

> Although the facts in a particular case must govern, and acceptable formula for the segregation is to consider as the portion of the total income applicable to the separate capital the usual interest on a long-term investment well secured; the remainder of the income, if any, is considered allocable to the personal efforts of the proprietor and consequently, community income.

While in most instances the Bureau of Internal Revenue accepts the tenets of local law on property ownership, it has developed its own formula in the present instance, which differs considerably from the California rule just described. Allocation

by the Bureau customarily involves the splitting of income between capital and services in the ratio which an eight percent return on annual average invested capital bears to an assumed reasonable salary allowance. The difference in the results of the "California" formula and that of the Bureau may be seen from the following example:

Facts:

Total income of venture		$100,000
Separate capital investment		25,000
Assumed rate of return on long-term investment well secured		8%

California method:

Separate income (8% of $25,000)		$ 2,000
Community income (remainder)		98,000

Bureau method:

Return on average invested capital (8% of $25,000)		$ 2,000
Reasonable salary allowance for proprietor		18,000
Ratios for apportionment:		
Applicable to separate property	($ 2,000) / ($20,000)	10%
Applicable to personal services	($18,000) / ($20,000)	90%
Separate income (10% of $100,000)		$ 10,000
Community income (90% of $100,000)		90,000

The Bureau's view of the situation has been accepted by the Tax Court in some cases (*e.g., Clara B. Parker, Executrix,* 31 B. T. A. 644; *J. Z. Todd,* 7 T. C. 399). However, in two fairly recent cases (*Lawrence Oliver,* 4 T. C. 684; *Ashley Manning,* 8 T. C. 537) the Tax Court in effect utilized the California rule.

It is also interesting to note that a third approach to this apportionment problem was adopted by the Tax Court in two other recent cases (*George W. Van Vorst,* 7 T. C. 826; *Hugh B. Tinling,* 7 T. C. 1393). It was there held that since the partners themselves by formal agreement had decided upon the amounts allowable as compensation for their personal services, only those amounts were community income and the remainder was attributable to the separate capital investments. This third method is less advantageous to most taxpayers than either of the other two described. Accordingly, it is advisable to consider the

possible tax consequences of including in a partnership agreement a statement as to the amounts of salaries to be allowed to each member of the firm.

A further comment appears to be in order with respect to the "Bureau" and "California" allocation formulae (methods 1 and 2 described above). In most cases, the decisions imposing these methods have utilized a 7% or 8% rate of return as "the usual interest on a long-term investment well secured." It is extremely doubtful whether it is currently possible to earn such a high rate on a secured long-term investment. In this period of cheap money, it is suggested that the application of a lower percentage to capital may be justifiable; this of course has the effect of increasing the community share of the income and thus minimizing the income taxes to be paid.

Another factor should also be remembered. Regardless of which method of apportionment is selected, it may result in an enhancement of both the original separate capital and community capital. If the community increment (*i.e.*, the community earnings) is not completely withdrawn from the business by the proprietor or partners, a second type of capital begins to accumulate. Consequently, in subsequent years any apportionment of income is further complicated by reason of the existence of three possible categories of income: that attributable to separate capital, to community capital, and to personal services. Adequate records are essential for the intelligent application of a formula in such a situation for either property or tax purposes.

OTHER FORMS OF COMMINGLING

As we know, commingling of community and separate property is more the rule than the exception. Minimization of the tax burden (gift and estate taxes as well as income tax) requires the proper classification of property and income. Such classification can be attained only at the price of maintaining appropriate records and being constantly aware of the principles involved.

In most cases the higher a couple's community income is in relation to their separate incomes, the lower the aggregate income tax will be. On the other hand, it is frequently advantageous if the separate tax deductions of a spouse exceed the community deductions. Where commingling has taken place,

certain presumptions in the Federal and California statutes and decisions will be relied upon by the Bureau of Internal Revenue for the classification of income and deductions. The application of these presumptions will sometimes work to the taxpayer's disadvantage, and although most of the presumptions are rebuttable, taxpayers are ofttimes unable to establish sufficient facts for this purpose.

For illustration take the case of tax deductions for charitable contributions and medical expenses. The marital community will minimize its taxes by treating these expenses as the husband's separate deductions, if his taxable income exceeds that of his wife. Such treatment, however, presupposes the payment of the expenses out of the separate funds of the husband. If, as is commonly the case, personal disbursements of this nature are made from a single family bank account containing undeterminable amounts of both community and separate funds, it will generally be presumed that they were withdrawn from the community rather than the separate funds in the account.

The tax disadvantage inherent in such a situation was vividly demonstrated in the recent Tax Court case of *Ernest W. Clemens,* 8 T. C. No. 12. Here the husband was denied a separate deduction for medical expenses paid out of a commingled bank account. To prove that his separate funds were used to defray the expenses, he showed that the family and living expenses (community) for the year exceeded by a considerable amount the total community funds deposited in the single bank account. The court held that this did not establish that the particular expenses in question had been paid from separate funds. This case dealt with a typical situation; most taxpayers with commingled bank accounts would be unable to adduce any evidence other than that presented by the petitioner here. Treatment of the medical expenses as a community deduction unnecessarily increased the taxes of this taxpayer, since his income was substantially greater than that of his wife. Furthermore, the splitting of the deduction required the additional elimination therefrom of 5% of his wife's adjusted gross income, as required by the Internal Revenue Code.

The *Clemens* case also involved deductions for charitable contributions which were paid out of the same commingled bank account. This item the court permitted the husband to deduct

in full on the theory that such expenses must have been paid out of his separate funds, since he had no power to give away community funds without the consent of his wife. This is an instance of the presumption working in favor of the taxpayer.

This discussion is not intended to imply that mere proof of payment of an expense out of a certain type of funds will characterize it as a separate or community tax deduction. Some deductions by their nature must be classified as separate or community charges. The situation discussed here concerns that large class of expenses which is on the borderline and, depending upon the form of payment, can be classified as one or the other. Medical expenses, for instance, could be considered as community deductions since they are in fact a family expenditure; on the other hand, they may be viewed as the separate deduction of a husband on the theory that he is legally responsible for the support of his family, including the providing of medical care. It is also important to point out that in addition to the establishment of adequate records to distinguish between classes of property, it is usually desirable for a marital community to open separate bank accounts for each type of funds on hand, *i.e.*, a separate account for the husband, one for the wife, and a community account. If these accounts are maintained properly, the difficulties of proof experienced by the taxpayer in the *Clemens* case should not occur.

DOMICILE

The question of domicile is always a basic one with respect to community property. A tax problem in this connection which recently came to the writer's attention may be of interest. An author domiciled in New York State, commenced the research work for the production of a book. After two years of such work, including a minor amount of writing on the book itself, the author and his wife changed their domicile to California. After another year or more of writing the tome was completed, sold to a publishing company and issued to the public. The question then arose as to whether the earnings of the author from the sales of the book were community income or his separate income. The problem is further complicated by Section 107 of the Internal Revenue Code which provides that where a work of art such as a book has taken three years or more to complete, and 80% or more of the income therefrom is re-

ceived in one year, such income may in effect be allocated ratably over the years during which the work was performed to determine the applicable tax rates.

In this case the Bureau of Internal Revenue contends that the income is the husband's, at least to the extent to which it was pro-rated under Section 107 to the years during which he was domiciled in New York. There is no recorded tax precedent on this question, but it seems to the writer that an equally tenable theory is that no income was earned from the book until it was completed. Since this occurred when the taxpayer and his wife were domiciled in California, it should follow that all of the proceeds were community income. It does not appear that Section 107 can change the character of this income; the section merely provides a device to relieve a taxpayer of the harsh tax results of receiving in one year, income earned over a long period of time.

GIFT AND ESTATE TAXES

Tax disadvantages of the community property system which act as an offset to the obvious income tax advantages are also illustrated in the Federal Estate and Gift Tax laws. For example, Section 811(e)(2) of the Internal Revenue Code prescribes principles for the taxation of community property at the death of a spouse which may involve a greater tax burden than would obtain if recognition were given to the basic principles of either the community property or the common law system.

The statute now provides for the inclusion in the taxable estate of the deceased spouse of the entire community property,

> "except such part thereof as may be shown to have been received as compensation for personal services actually rendered by the surviving spouse, or derived originally from such compensation or from separate property of the surviving spouse."

However, it is further provided that

> "in no case shall such interest included in the gross estate of the decedent be less than the value of such part of the community property as was subject to the decedent's power of testamentary disposition."

In the typical case where the husband has been the sole "breadwinner" of the family, the effect of these provisions is to include all of the community property in the husband's taxable

estate if he dies first, and at least half in the wife's estate if she should predecease her husband. Under the community property theory that the wife has a "present, existing and equal interest" in the community, only one-half of the community property would be included in the husband's estate, if he dies first. On the other hand, in a common law jurisdiction, if the wife were to die first in the example cited, none of the property would be taxed to her at her death. The tax disadvantage resulting from the "middle ground" theory of the statute is obvious. Unfortunately, however, the residents of the community property states have no choice but to swallow this pill, since the provision was held to be constitutional by the United States Supreme Court in *Fernandez v. Wiener,* 326 U. S. 340.

In view of the inclusion of all of the community property in the husband's estate in the usual case, the question arose as to the income tax status of income from community property received by the estate of the deceased husband during administration. The courts have held (*e.g., Bishop v. Com.,* 152 Fed. (2d) 389), and the Bureau of Internal Revenue has agreed (G. C. M. 25008), that income on property acquired on or after July 29, 1927 is divisible between the estate and the surviving widow; income derived from property acquired prior to that date is reportable by the estate.

There was also the related question of the tax treatment of the gain or loss on the sale of community property after death. The established rules, which appear to be logical, are as follows: As to "new" community property—gain or loss from sale of the wife's one-half share is measured by the difference between the selling price and the adjusted cost of such share to the community, and is taxable to her; gain or loss on the remaining one-half share (which is regarded as property of the estate) is measured by the difference between the selling price and the value of such share as of the date of the death of the husband. As to "old" community property—the entire gain or loss from a sale during administration is taxable to the estate and is measured by the difference between the selling price and the fair market value at the time of death. If either class of property is sold by the recipients after the estate has been closed, the basis for determining gain or loss thereon would be the same as that described above for the particular class received.

In connection with the estate taxation of community property it is well to recall Section 201.5 of the Probate Code of California. This section provides that upon the death of a spouse, all personal property acquired by the spouses while domiciled elsewhere, which would not have been the separate property of either if acquired while domiciled in California, shall be treated as though it were community property. There is no reason to doubt that the Bureau of Internal Revenue will avail itself of this statutory authority to ascribe the community character to property, with the consequent possible estate tax disadvantages described previously. It is therefore essential that we inform individuals who have come to California from other states of the potentialities of this provision. The problem relates not only to personal property found in the estate of the decedent, but also to real property purchased with funds which would have been classified as community property under the rule of the Statute. The District Court of Appeal, Second Appellate District, so held very recently in a case involving California Inheritance Tax (*The Matter of Petition of Marguerite W. Miller and Vivian Miller,* 80 A. C. A. No. 6, p. 859).

In connection with the Federal Gift Tax, space permits mention of only one phase. Under Section 1000(d) of the Internal Revenue Code all gifts of community property are considered to be gifts of the husband, except such portion as can be shown to have been received as compensation for personal services of the wife, or derived originally from such compensation or separate property of the wife. This is similar to the Estate Tax rule described above.

The Treasury Department has ruled (Reg. 108, Sec. 86.2(c)) that where a husband or wife converts separate property into community property there is no taxable gift. There is no specific statutory authority for this Regulation. However, it appears to be a logical amplification of the apparent thinking of Congress, *i.e.,* that community property as a separate class does not exist for tax purposes, but must be traced back and attributed to its source. Certainly if a husband transmutes his separate property into community property, taxwise there is no change in character, since at his death, or if he makes a gift thereof prior to death, it will be assumed to be his property in spite of the transmutation.

In many instances income tax advantages will accrue from this type of gift-tax-free conversion. However, such action should be recommended only with extreme caution, because of the important estate tax disadvantage which may result. It is true that if a husband with a considerable separate estate converts it into community property, from then on his income tax will be lower. However, if his wife predeceases him, at least one-half of this estate will be taxable at her death, whereas if the conversion had not taken place, no such tax would be assessed. When we have acquired the knack of accurately forecasting death, we will be able to make tax decisions of this sort with impunity; until then, caution is the by-word.

CONCLUSION

As may be seen from the foregoing commentary, which only scratches the surface, the community property system is not all gravy even taxwise. In the foreseeable future, most of the problems relating to income taxes may be eliminated, since there appears to be a good chance that Congress will adopt some form of the so-called "Surrey Plan." This plan would permit husbands and wives everywhere to split their combined income

equally for Federal Income Tax purposes, which of course goes even further along the line of tax saving than the community property set-up.

If the law is amended in this respect, California residents will lose their somewhat preferred income tax position, but will nevertheless continue to be saddled with the responsibilities and disadvantages of the community property system, some of which have been mentioned in this article. California marital communities may still be subject to potentially higher estate taxes than those in common law states, and attorneys and accountants will not be relieved of the complex problems related to property accounting, divorce and separation, probate, etc.

It is imperative that we be constantly alive to the many specialized problems which must be solved in a community property jurisdiction. Whether the income tax law is changed or not, this constitutes one of the most fruitful fields for service to clients.

PROBLEMS OF FEDERAL TAXATION INCIDENT TO DIVORCE AND SEPARATION

By Clifford E. Royston, of the Los Angeles Bar

PRIOR to 1942, payments between husband and wife arising out of separation or divorce were ignored for income tax purposes. A husband who had agreed (or been instructed by judicial action) to make payments for the support of his former wife was taxable on his entire income and was not allowed a deduction for the payments made. With the approach of the war, and consequent tremendous increase of income taxes, some unfortunate husbands found themselves in the position of paying more than their total income in taxes and alimony. Even for those who were not in this disastrous situation, the pinch was becoming more acute every year.

To ameliorate this situation, the Revenue Act of 1942 added new Sections 22(k) and 23(u) to the Internal Revenue Code, which provide for the inclusion in the taxable income of the wife, and the deduction from the taxable income of the husband, of certain payments. These sections read as follows:

> Sec. 22(k). "ALIMONY, ETC., INCOME.—In the case of a wife who is divorced or legally separated from her hus-

band under a decree of divorce or of separate maintenance, periodic payments (whether or not made at regular intervals) received subsequent to such decree in discharge of, or attributable to property transferred (in trust or otherwise) in discharge of, a legal obligation which, because of the marital or family relationship, is imposed upon or incurred by such husband under such decree or under a written instrument incident to such divorce or separation shall be includible in the gross income of such wife, and such amounts received as are attributable to property so transferred shall not be includible in the gross income of such husband. This subsection shall not apply to that part of any such periodic payment which the terms of the decree or written instrument fix, in terms of an amount of money or a portion of the payment, as a sum which is payable for the support of minor children of such husband. In case any such periodic payment is less than the amount specified in the decree or written instrument, for the purpose of applying the preceding sentence, such payment, to the extent of such sum payable for such support, shall be considered a payment for such support. Installment payments discharging a part of an obligation the principal sum of which is, in terms of money or property, specified in the decree or instrument shall not be considered periodic payments for the purposes of this subsection; except that an installment payment shall be considered a periodic payment for the purposes of this subsection if such principal sum, by the terms of the decree or instrument may be or is to be paid within a period ending more than 10 years from the date of such decree or instrument, but only to the extent that such installment payment for the taxable year of the wife (or if more than one such installment payment for such taxable year is received during such taxable year, the aggregate of such installment payments) does not exceed 10 per centum of such principal sum. For the purposes of the preceding sentence, the portion of a payment of the principal sum which is allocable to a period after the taxable year of the wife in which it is received shall be considered an installment payment for the taxable year in which it is received. (In cases where such periodic payments are attributable to property of an estate or property held in trust, see section 171 (b).)"

Sec. 23(u). "ALIMONY, ETC., PAYMENTS.—In the case of a husband described in section 22(k), amounts includible under section 22(k) in the gross income of his wife, payment of which is made within the husband's taxable year. If the amount of any such payment is, under section 22(k)

or section 171, stated to be not includible in such husband's gross income, no deduction shall be allowed with respect to such payment under this subsection."

The difficulties arise because all payments are not taxable income to the wife, nor are all payments which are taxable to the wife deductible by the husband.

It seems clear that the basic thought in enacting this legislation was that payments made to a wife incident to a divorce or separation fall into two general categories: (1) "Capital" payments, that is, amounts paid to the wife to compensate her for the loss of her interest in property accumulated by the parties prior to the date of the separation or divorce; (2) "Income" payments, that is, amounts paid to the wife by virtue of her continuing right to support from the husband. As the capital obligation is ordinarily satisfied by a division of property theretofore acquired by the parties, it would be manifestly unfair to include such payments in the income of the wife. On the other hand, income payments raised the fiscal problems already mentioned and should be includible in the income of the wife.

It is quite true that most divorces and separations do involve financial arrangements of the two types mentioned. At first glance, it would seem fairly easy to determine whether a given payment was in the nature of a capital division or a division of future income for the purpose of support. In fact, however, this is frequently not the case. For example, if the chief asset of the parties consists of a going business which is incapable of physical division it is often provided that the wife shall receive a lump sum, to be paid over a period of years, in satisfaction of her rights in the business. These payments are in satisfaction of a capital obligation; yet in fact they will probably be paid by the husband out of his income in future years. Again, her rights in accumulated capital may be satisfied by a relatively small lump sum payment and a liberal allowance for future support. On the other hand, the wife may receive a greater share of accumulated capital than that to which she would ordinarily be entitled and in return accept a lesser amount for future support. Endless variations are, of course, possible.

It might be feasible to determine the matter on the facts of each particular case, but the manifest complexities of this approach motivated the Congress to adopt an arbitrary set of stand-

ards to be used in determining whether the particular payment was to be included in the income of the wife or not. These standards are both a sorrow and a joy to the practitioner. To the unwary, they may result in the imposition of onerous tax burdens on one party without any compensating benefits to the other, while careful consideration of the standards as applied to particular factual situations may result in very large tax savings.

In an article of this scope it is impossible to do more than mention a few of the most important problems which may occur. Furthermore, the statutory provisions are so recent that many questions are as yet unanswered. It is highly desirable that each factual situation be carefully weighed in the light of the law and the decisions as they may then stand.

As will be seen from an examination of Internal Revenue Code Section 22(k) there are several separate elements which must be present if the payment is to be includible in the income of the wife. For convenience, they will be considered more or less in the order in which they appear in the section.

1. *Divorce or legal separation.* There must have been a judicial proceeding resulting in an order or decree of separation or divorce. *Frank J. Kalchthaler,* 7 T. C. 625, C. C. H. Dec. 15,336 (1946). A private agreement of the parties that they shall separate is not sufficient. Furthermore, only payments made subsequent to the entry of such order or decree are includible. If a property settlement agreement is entered into and is not followed by a legal order or decree, no portion of the amount paid is includible in the income of the wife. *Charles L. Brown,* 7 T. C. 715, C. C. H. Dec. 15,369 (1946). In instances where the parties desire to separate but do not desire to formalize their new status with a judicial proceeding a serious problem is presented. The desirable objective of splitting the family income may still be achieved, however, by the device of providing that a portion of the husband's income shall remain community income. Instead of providing that the wife shall receive $300.00 per month and accompanying this with the standard provision that all earnings of either parties after the date

of the agreement shall be separate in nature it can easily be provided that the first $600.00 per month earned by the husband shall be considered to be community income, of which he will pay one-half to the wife, while the remainder of his income and assets shall be considered to be separate in nature. Where the husband has substantial earnings from personal services, this has the effect of including in the income of the wife one-half of the community income (that is the $300.00 per month which she will receive from her husband). It thus relieves the husband from tax on the payments made by him to his wife.

A Californa interlocutory decree of divorce meets the test and payments made subsequent to such decree are includible under this section. I. T. 3761, 1945 C. B. 76. An annulment which holds the marriage void *ab initio* is not such a decree as will make payments includible in the income of the wife, as it is neither a divorce nor a legal separation. *Bureau letter of Dec. 8, 1944, 454 C. C. H. p. 6092.* An annulment for causes making the marriage voidable would seem to lead to a contrary result.

Another problem which arises in connection with this requirement concerns the effect of an invalid decree of divorce. In the case of residents of Connecticut who obtained a divorce in Mexico and subsequently remarried in reliance upon such decree, the Bureau of Internal Revenue has ruled that payments made pursuant to such decree are includible in the income of the wife despite the fact that the Mexican decree was almost surely invalid. G. C. M. 25250, 1947 C. B. No. 18, p. 2. This ruling seems more generous than accurate. A serious question could still be raised as to the status of payments made under an invalid decree—especially where the decree is void for lack of jurisdiction.

2. *Periodic Payment.* To qualify, the payments must be periodic in nature. A lump sum payment is clearly excluded by reason of this requirement. On the other hand, payments which are to be made at stated intervals for an indefinite period of time (as "until the death or remarriage of the wife") are clearly within the rule. A special rule is prescribed for payments which, while made at intervals, are to continue for a fixed period of time. Such payments are includible if the total amount is to be paid over a period of more than ten years, but

only to the extent that the amount received in any one year does not exceed ten percent (10%) of the total. An agreement to pay $100,000.00 in five equal annual installments would not qualify under this rule. However, an agreement to pay $100,000.00 in eleven equal annual installments would qualify. Under the 10% qualification only $10,000.00 would be includible in the income of the wife in any one year. The Bureau has taken the position, however, that the limitation does not apply to the payment of back installments. Reg. 111, Sec. 29.22(k)—1(c). Thus if $10,000.00 due in the current year were paid to the wife and

an additional $10,000.00 due in a previous year were paid during the same year the entire $20,000.00 would be taxable to the wife. Amounts prepaid on installments due in future years are within the 10% limitation. These installment payment provisions offer substantial opportunities for adjusting future income tax liabilities of the parties. Where the husband has a large income it may be desirable for the wife to accept future installment payments in lieu of a greater share of capital at the time of the divorce or separation. In this fashion future tax liability will be shifted in part from the husband to the wife who will usually be taxable at much lower rates.

As to periodic payments which are indefinite as to duration a serious problem is raised when substantial amounts of back payments are in default. The collection of these defaulted payments in one year may result in a substantial tax burden as they are includible in the income of the wife without limitation. This is true even if the decree was entered many years prior to the 1942 amendments and even in cases where the payments were due prior to the 1942 amendments. One way of reducing this burden is to provide for receipt of the past due amounts over two or more years.

3. *Legal obligation.* The payments must be in discharge of a legal obligation which is imposed upon the husband by reason of the marital or family relationship. Payments which are made by reason of the wife's continuing right to support from her husband are clearly within this rule. Under some circumstances payments which are made by reason of the wife's rights in accumulated capital of the parties may also qualify. However, payments would not qualify if they were made in discharge of a loan previously made by the wife to the husband.

The requirement of legal obligation raises some problems when the parties during the pendency of the marriage enter into property arrangements which are allowed to continue to subsist after a divorce or legal separation. The Code section requires that the payments be made pursuant to the judicial decree or pursuant to a written instrument incidental to such decree. An agreement which is entered into a considerable period of time prior to the decree will be held not incidental to the decree. Reg. 111, Sec. 29.22(k)-1. If the agreement is executed at

approximately the time when proceedings are commenced the test is met. *Tuckie G. Hesse,* 7 T. C. 700, C. C. H. Dec. 15,367 (1946). Any problem in this connection is usually solved by incorporating the provisions of the written agreement into the decree, in which case the payments will clearly be within the Section.

4. *Support of Children.* The Statute excludes amounts which are specified as being for the support of minor children of the husband. A compensating advantage to this exclusion is to be found, of course, in the fact that the husband will be able to claim the children as dependents if he contributes more than one-half of their support and each child has gross income of less than $500.00. I. R. C. Sec. 25(b). In cases where his payments do not exceed one-half of their support, he will be fully taxable on such payments and will not be allowed to claim them as dependents. Where the decree or agreement provides for payments for the support of children the amounts should be sufficient so that it may be claimed that the husband furnishes more than one-half of the total support. The alternative solution is to provide for payments for the support of the children in a nominal amount and correspondingly increase payments for the support of the wife. Payments for the support of the wife will be fully taxable to her (and deductible by the husband) but the wife will be able to claim the children as dependents and thus secure a compensating tax advantage.

Where a separate amount is specified as being for the support of children that amount will be considered as having been paid for that purpose even though the full amount is not paid. Thus if the husband is ordered to pay $100.00 per month for the support of his wife and $100.00 for the support of minor children and actually pays only $150.00 during a given month, $100.00 of said sum will be considered as having been paid for the support of the children and only $50.00 for the support of the wife.

The decree or agreement must specify the amount payable for support of children, *Budd v. Commissioner,* ...... Fed. (2d) ......, 472 U. S. T. C. Par. 9302 (C. C. A. 6, 1947). Absent such a specification, the entire amount is taxable to the wife. *Dora H. Moiteret,* 7 T. C. 640, C. C. H. Dec. 15,352 (1946);

Elsa B. Chapin, T. C. Memo., July 28, 1947, C. C. H. Dec. 15,947(M).

5. ***Amounts attributable to property transferred.*** Special problems arise when the obligations of the husband are discharged by a transfer of property. It should first be noted that no taxable income results to the wife when she receives a lump sum settlement in cash, securities and/or other property. Future income attributable to such property will, of course, be fully taxable to the wife. The problems arise when the husband is obligated to make indefinite payments for the support of his wife and discharges such obligations by a transfer of property in trust or otherwise. If the husband were obligated to pay $5,000.00 per year for the support of his wife he might discharge this obligation by a transfer of property valued at $100,000.00 to a trustee, the trustee being instructed to pay to the wife the amount of $5,000.00 per year. The full amount received by the wife will be taxable to her. No portion of the income of property so transferred will be includible in the income of the

husband. If, however, the trustee must invade corpus in order to make the payment of $5,000.00 the wife is nonetheless taxable upon the full amount received. Neither the husband nor anyone else secures any compensating tax advantage for this invasion of corpus. If the payment from the trust to the wife is restricted to the net income thereof, and the husband makes up the difference, the husband secures a deduction for this excess payment. Even where the husband is reimbursed from the corpus of the trust for the excess payment, it would seem this result can be achieved. This latter provision involves complex trust problems.

In a case where the husband discharges his legal obligation by the purchase of an annuity for the benefit of his wife, the full amount received under the annuity contract will be taxable to the wife and no deduction will be allowed the husband. If the annuity were made payable to the husband a much more favorable result is obtained. In this instance, the wife is still taxable on the full $5,000.00 received. The husband, however, is taxable only on a portion of the annuity (3% per annum of the purchase price until the full purchase price has been received tax free) and secures a deduction for the full amount paid to his wife.

Another potential disaster which is incorporated into innumerable property settlement agreements is the provision that insurance policies on the life of the husband shall be transferred to the wife. While the matter is not yet finally settled, there is reason to believe that when such policies mature the full amount may be held taxable income in the hands of the wife. See I. R. C., Sec. 22(b); Reg. 111, Sec. 29.22(b)-4. At first glance, the proceeds would seem not to constitute a "periodic" payment. However, they are received *in lieu of* further "periodic" payments. Furthermore, the policies frequently allow payment in annuity form upon maturity. A strong argument for taxability could be made. Even in the case of a relatively small policy the tax effects such a holding would wreak are obvious. In the case of a large policy the effect would be to deprive the wife of a very substantial portion of the benefits which it was intended to give her. In situations where the parties are still relatively young an alternative solution is to increase the current amount payable for the support of the wife and then have her

take out new policies on the life of her erstwhile husband. When these policies are matured the proceeds will be received by the wife tax free. Meanwhile, the husband if he desires can, of course, retain the old policies. If these continue to name his wife as beneficiary, the proceeds of these policies will also be received by the wife tax free. The problem arises only when title to the policies is transferred to the wife.

Conclusion. The day when tax problems were a luxury for the rich are gone forever. Now even the wage earner must carry a share of the burden and it seems fair to conclude that such will be the case for many years to come. In the field of divorce the highly technical rules incorporated into the tax structure have the result that small differences in phraseology can mean large differences in taxation which can persist over the entire remaining lives of the parties. Even in the case of parties of modest means the problems are worthy of our serious consideration.

THE DOMESTIC RELATIONS DEPARTMENT OF THE SUPERIOR COURT

By E. L. Saunders, of the Los Angeles Bar

WITH the exception of a few courts, such as the criminal, psychopathic, juvenile and adoption departments, all of fifty-odd departments of the Superior Court in Los Angeles are domestic relations departments, in that they all hear contested and default divorces, separate maintenance and paternity cases. However, this article shall deal primarily with Department 8 of the Superior Court of the County of Los Angeles, which is affectionately known to attorneys as "the war department." Department 8 has been designated as the department of our court to handle the proceedings on orders to show cause and motions *in re* attorneys' fees, court costs, alimony *pendente lite,* allowance for support, custody of children and restraining orders, contempts, modifications, and writs of habeas corpus in domestic relations cases.

Because of the nature of the litigation, there exists between the litigants who appear in Department 8, a bitterness and animosity which is not usually present in other civil departments. The spirit of compromise and fair play between the parties is

thus at a minimum. The husband desires to escape as lightly as possible and the wife seeks to obtain the last dollar permitted. It is with the rules of law and principles relating to this contest that we are here concerned.

This article is not an exhaustive treatise on the subject, but rather deals with some of the familiar and some of the not-so-familiar rules with which it has been the privilege of the writer to come in contact in his practice before the domestic relations court and is written from the viewpoint of the practitioner.

The actual procedure in court with reference to the answer of the call of the calendar are set out in detail in the March 11, 1947, issue of the *Los Angeles Daily Journal* by the Hon. Fred Miller, Judge of the Master Calendar of the domestic relations court.

A litigant usually is first brought into Department 8 by the process of an order to show cause which is issued by the Judge upon the affidavit of one of the parties.[1] There is a printed form distributed by the County Clerk on the fifth floor of the Hall of Records that attorneys use in this connection.

Generally the order to show cause must be personally served upon the party. However, jurisdiction can be obtained where there is an attorney of record by way of a motion which is not personally served on the party, but served by mail upon such attorney of record.[2] Further, it has been held that an order for attorneys' fees and alimony can be made *ex parte*.[3]

Where the action is one for divorce, separate maintenance, or annulment of a voidable marriage, attorney's fees and alimony *pendente lite* may be awarded in the proceedings under California Civil Code, Sec. 137. However, if the case is one of annulment of a void marriage, then no such award can be made.[4]

The very recent case of *Armstrong v. Armstrong,* 81 A. C. A. 372, at 383, states that on an order to show cause, court costs cannot be awarded to the attorney, which changes the practice long established in Department 8.

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[1]Civil Code, Sec. 137.
[2]*Miller v. Miller,* 57 Cal. App. (2d) 354.
[3]*Reed v. Reed,* 40 Cal. App. 102.
[4]*Parmann v. Parmann,* 56 Cal. App. (2d) 67. But attorney fees can be awarded in a void marriage annulment where there is a minor child, the theory being that it is for the benefit of and the protection of the minor child. See *infra.*

Under Civil Code Sec. 140, "the court may require the husband or wife . . . to give reasonable security for providing maintenance or making any payments required under the provisions of this chapter, and may enforce the same by the appointment of a receiver, or by any other remedy applicable to the case." Thus, a receiver may be appointed on a petition showing sufficient cause, and this application is directed to, and the order is made in, Department 34 of our Superior Court. Then, after a receiver is appointed in Department 34, an application should be made in Department 8 of an order for alimony, support of child, if there be one, and attorney's fees.

The court has the power to appoint a receiver upon an *ex parte* order and without previous notice to the defendant,[5] and such receiver can take custody of and sell the property whether it be community or separate property of the husband, to enforce a judgment for separate maintenance in favor of the wife.[6] It should always be remembered that in these separate maintenance actions the court has continuing jurisdiction to change or to enforce from time to time its orders for support;[7] and the applications should be made in Department 8.

The Civil Code, Section 140, further gives the court jurisdiction and power to require one of the parties to give surety for payments ordered by the court. In one case the court required the husband to pay $150 a month alimony and further ordered him to establish a trust fund of $10,000, as security for the payments of such alimony.[8] In another case the court ordered the defendant to authorize a broker to sell out a brokerage account, deliver the proceeds to a trustee to be chosen by the attorneys, which money was to be used to support the plaintiff and the children.[9]

The rule is often loosely stated that if the child of the parties is in another state the court has no jurisdiction over the child and

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[5]*Reynolds v. Reynolds*, 21 Cal. (2d) 580.

[6]*Witaschek v. Witaschek*, 56 Cal. App. (2d) 277.

[7]*Smith v. Smith*, 49 Cal. App. (2d) 716.

[8]*Nichols v. Superior Court*, 1 Cal. (2d) 589; *Nichols v. Nichols*, 135 Cal. App. 488. Also see Rule 28 of the Superior Court Rules of Los Angeles County for the requirement that an *ex parte* order appointing a receiver must be made returnable in 10 days.

[9]*Lisenbee v. Lisenbee*, 42 Cal. App. 567; Code of Civil Procedure, Secs. 564 and 566.

cannot make an order for its support. This is not altogether true. It is true that the child must be in the State of California before Department 8 can make an order in a habeas corpus proceedings or in a divorce case where there is substituted service: but the court can make an order for support of a non-resident child where the parents have submitted to the jurisdiction of the court.[9a]

Aside from orders to show cause and motions re fees, alimony, support, etc., Department 8 hears a great many orders to show cause in re contempt. Since this is a quasi-criminal proceedings, the citation or order to show cause must be served personally on the alleged contemnor. However the process can be served on his or her attorney of record where he is concealing himself, outside the jurisdiction of the court, or has taken a child which is the subject of controversy and left the state.[10] It is elementary in these contempt hearings that the following

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[9a] *Dolgoff v. Dolgoff*, 81 A. C. A. 185.

[10] *Foley v. Foley*, 120 Cal. 33; *Shibley v. Superior Court*, 202 Cal. 738; *Olcott v. Superior Court*, 68 Cal. App. (2d) 603; *In re Meyer*, 131 Cal. App. 41.

must be proved: the court order, the violation, the ability to comply, and notice or knowledge of the court order. Aside from the many questions which arise from the problems of constructive contempts or contempts in presence of the court, one question the client invariably asks is, "how long can they put me in jail?" It is the usual procedure in Department 8, if a party is found in contempt, to suspend sentence, order the party to comply and make up delinquencies, and order the contemnor to return on a certain date to see if there is compliance with the court order. Code of Civil Procedure, Section 1218, among other provisions, limits the sentence to five days in jail. However, there are cases where the contemnor may be placed in jail for longer than five days; to wit, until he has complied with the court order; *In re Salkin,* 5 Cal. App. (2d) 436. The distinction appears to be that where the court finds that he had the ability to comply at the time the order was made but now does not have such ability, then the penalty is limited to the five day period; but

where the contemnor has the present ability to comply with the court order he may be incarcerated until he does comply.

Department 8 handles all modifications of domestic relations orders which can be applied for either in the form of an order to show cause directed to the party, and personally served on the party, or by way of a motion where there is an attorney of record, in which case the notice is served by mail on the said attorney. These modifications are directed toward changing orders made *pendente lite*, in interlocutory decrees, and in other orders of the court, and deal with lowering or raising orders for support of children or alimony, with changing the custody of children, or changing the times of visitation.[11] The paramount problem of proof is that of showing a material change in the circumstances. When such a change is shown the court has power to modify the old order or decree. There is a situation where the court order for payments of money may not be modified: the case where a property settlement agreement is approved, and is incorporated or made part of the decree, and one party is to make periodic payments. Whether the amount of these periodic payments can be reduced or increased depends on the nature of the payments. If the payments are in effect and essence a phase of the property settlement or property division then the court order can never be modified or changed; but if their effect and essence is for alimony, then like any alimony award they can be modified or changed.[12] Of course, a property settlement agreement like any other business contract can be set

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[11]Civil Code, Sec. 139.

[12]*Hough v. Hough,* 26 Cal. (2d) 605; *Adams v. Adams,* 29 Cal. (2d) 621.

aside for fraud, duress, undue influence or violation of a confidential relationship.[13]

Department 8 is looked upon by many attorneys as an uninteresting court, handling only simple matters. On the contrary it is one of the most interesting because, by the very nature of its cases, it deals in and with the emotions of people.

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[13]*Holloway v. Holloway*, 79 A. C. A. 52.

STATEMENT OF THE OWNERSHIP, MANAGEMENT, CIRCULATION, ETC., REQUIRED BY THE ACTS OF CONGRESS OF AUGUST 24, 1912, AND MARCH 3, 1933

of LOS ANGELES BAR BULLETIN, published monthly at Los Angeles, California, for October 1, 1947.

State of California, County of Los Angeles.—ss.

Before me, a Notary Public in and for the state and county aforesaid, personally appeared Robert M. Parker, who, having been duly sworn according to law, deposes and says that he is the business manager of the Los Angeles Bar Bulletin, and that the following is, to the best of his knowledge and belief, a true statement of the ownership, management (and if a daily paper, the circulation), etc., of the aforesaid publication for the date shown in the above caption, required by the Act of August 24, 1912, as amended by the Act of March 3, 1933, embodied in section 537, Postal Laws and Regulations, printed on the reverse of this form, to wit:

1. That the names and addresses of the publisher, editor, managing editor, and business managers are:

Publisher—Los Angeles Bar Association, 1124 Rowan Bldg., Los Angeles 13, Calif.
Editor—Frank S. Balthis, Jr., 640 Rowan Bldg., Los Angeles 13, California.
Managing Editor—None.
Business Manager—Robert M. Parker, 241 E. 4th St., Los Angeles 13, California.

2. That the owner is: (If owned by a corporation, its name and address must be stated and also immediately thereunder the names and addresses of stockholders owning or holding one per cent or more of total amount of stock. If not owned by a corporation, the names and addresses of the individual owners must be given. If owned by a firm, company, or other unincorporated concern, its name and address, as well as those of each individual member, must be given.) Paul Fussell, President, 900 Title Insurance Bldg., Los Angeles 13, California. Clarence B. Runkle, Secretary, 1219 Bank of America Bldg., Los Angeles 14, California. Ewell D. Moore, Treasurer, 620 Subway Terminal Bldg., Los Angeles 13, California. Los Angeles Bar Association, 1124 Rowan Bldg., Los Angeles 13, California.

3. That the known bondholders, mortgagees, and other security holders owning or holding 1 per cent or more of total amount of bonds, mortgages, or other securities are: (If there are none, so state.) None.

4. That the two paragraphs next above, giving the names of the owners, stockholders, and security holders, if any, contain not only the list of stockholders and security holders as they appear upon the books of the company but also, in cases where the stockholder or security holder appears upon the books of the company as trustee or in any other fiduciary relation, the name of the person or corporation for whom such trustee is acting, is given; also that the said two paragraphs contain statements embracing affiant's full knowledge and belief as to the circumstances and conditions under which stockholders and security holders who do not appear upon the books of the company as trustees, hold stock and securities in a capacity other than that of a bona fide owner; and this affiant has no reason to believe that any other person, association, or corporation has any interest direct or indirect in the said stock, bonds, or other securities than as so stated by him.

5. That the average number of copies of each issue of this publication sold or distributed, through the mails or otherwise, to paid subscribers during the twelve months preceding the date shown above is.................... (This information is required from daily publications only.)

ROBERT M. PARKER,
Business Manager.

Sworn to and subscribed before me this 1st day of October, 1947.

[Seal]

MARGUERITE F. CRIPPS,
Notary Public in and for the County of Los Angeles, State of California.

My commission expires January 3, 1948.

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